U.S. COMMODITY FUTURES TRADING COMMISSION
ENSURING THE INTEGRITY OF THE FUTURES & OPTIONS MARKETS

Commodity Futures Trading Commission
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Remarks

Remarks of Chairman Gary Gensler, Over-the-Counter Derivatives Reform, Council of Institutional Investors, Washington, D.C.

April 13, 2010

Good morning. I thank the Council of Institutional Investors for inviting me to speak this morning. I appreciate all the work you do, along with the Investors' Working Group, to protect investor interests in America. I recall working closely with you when I worked on the Sarbanes-Oxley Act in 2002, and I look forward to continuing to get the Council's views on essential financial reform legislation.

As the Senate debates regulatory reform in the coming weeks, one critical issue will relate to the over-the-counter derivatives marketplace. Though there were many causes of the 2008 financial crisis, most would agree that over-the-counter derivatives played a central role.

History of Over-the-Counter Derivatives

Derivatives have been around since the Civil War, when grain merchants came together to hedge the risk of changes in the price of corn, wheat and other grains on a central exchange. These derivatives are called futures. Nearly 60 years and a financial crisis after they first traded, Congress brought Federal regulation to these markets. In the 1930s, the Commodity Exchange Act, which created the CFTC's predecessor, became law.

From the 1930s until 1980, all derivatives and publicly listed securities were subject to comprehensive oversight by federal regulators. This means that they were traded on regulated exchanges and policed to ensure fair and orderly trading. Things began to change in 1981 with the first over-the-counter derivative transaction. Instead of trading through exchanges and being cleared through clearinghouses, over-the-counter derivatives are generally transacted bilaterally and are not subject to regulation.

Over-the-counter derivatives were at the center of the 2008 financial crisis. They added leverage to the financial system with more risk being backed up by less capital. Taxpayers bailed out AIG with $180 billion when that company's ineffectively regulated $2 trillion derivatives portfolio nearly brought down the financial system – that means that every person in this room has $600 invested in AIG. These events demonstrate how over-the-counter derivatives – initially developed to help manage and lower risk – can actually concentrate and heighten risk in the economy and to the public. The time has come to bring comprehensive regulation to the over-the-counter derivatives marketplace and to the dealers who sell derivatives products.

Essential Components of Reform

As of today, the U.S. House of Representatives and the U.S. Senate Banking Committee have both passed historic regulatory reform legislation that addresses the over-the-counter derivatives markets. The Senate Agriculture Committee also will soon release its draft of derivatives legislation. It is essential that any reform that passes accomplishes three goals.

First, it must comprehensively regulate any entity that deals derivatives. This includes Wall Street banks as well as other non-bank dealers.

Second, we must bring all standardized over-the-counter derivatives onto transparent and regulated exchanges or similar trading venues to lower risk and improve pricing in the marketplace.

Third, to further lower risk, we must bring all standardized over-the-counter derivatives into central clearinghouses. Clearinghouses in the futures markets have been around since the late-19th century and have functioned both in clear skies and during stormy times – through the Great Depression, numerous bank failures, two world wars and the 2008 financial crisis – to lower risk to the American public.

Regulating the Dealers

One of the past justifications for leaving over-the-counter derivatives unregulated was that the institutions that deal derivatives were already regulated. The problem, however, was that the institutions were not expressly regulated for their derivatives business. AIG, for example, was a regulated insurance company, but their derivatives affiliate was not subject to any meaningful regulation. Just because a bank, an insurance company or an oil company may be regulated for one line of business does not mean that it also is regulated for all of its risky endeavors.

Financial reform must bring comprehensive regulation to derivatives dealers. Prudential regulators should be authorized to set capital and margin requirements for derivatives dealers to protect the public from bearing the costs if dealers fail, as the public was forced to do with AIG. Dealers should be required to meet robust business conduct standards to protect market integrity and lower risk and should be subject to stringent record-keeping requirements.

It is essential that reform cover all derivatives dealers and not just the big banks on Wall Street. After all, AIG was not a bank dealer. Any entity that holds itself out to the public as a dealer should be subject to comprehensive and consistent regulation. This should include any entity making markets in OTC derivatives, such as banks, nonbanks and algorithmic – or high-frequency – traders.

The bill passed by the House of Representatives and the bill passed out of the Senate Banking Committee have these essential protections. Other than foreign exchange swaps, both bills comprehensively regulate dealers for all of their derivatives transactions – both standardized and customized and both cleared and bilateral.

Enhancing Transparency in the Marketplace

Over-the-counter derivatives trade out of sight of regulators, market participants and the public. Regulatory reform must bring transparency to this dark marketplace to both lower risk and improve pricing.

To bring market transparency to the regulators, Congress should enact robust recordkeeping and reporting requirements for all derivatives transactions. This would include on-exchange transactions and bilateral transactions.

Bringing transparency to the regulators, however, is not enough. We must also bring transparency to the public. Right now, when Wall Street banks enter into derivatives transactions with their customers, they know how much their last customer paid for the same deal, but that information is not made publicly available. They benefit from internalizing this information. The buyer and seller never meet in a transparent market, and Wall Street profits from wider spreads between the bids and the offers. This is in stark contrast with the regulated futures and securities markets, where the public can see the price of the last transaction traded on a regulated exchange as well as the latest bids and offers.

Further, one of the lessons from the 2008 financial crisis was that transparency is critical to lowering risk in the marketplace. We all recall the inability of the Federal Government and Wall Street to price assets during the crisis – assets that we began to call “toxic.” It is essential that reform enables better pricing of those assets.

To best promote public market transparency, regulation should require that all standardized over-the-counter derivatives trade on regulated exchanges or similar trading venues, called swap execution facilities. From the Council’s public letters, I know that we share this goal. The more transparent a marketplace, the more liquid it is and the more competitive it is. Transparent trading venues would enable all market participants – from the oil producer to the retailer importing products – to lower the cost of hedging their risk. This also would lower costs to their customers and lower risk to their enterprises.

Exchanges and swap execution facilities also would lower risk in the system by enabling clearinghouses to get reliable pricing information and determine the liquidity of particular contracts. This is essential for clearinghouses to adequately manage their risk and thus lower risk to the economy and the public.

Swap execution facilities provide four essential services that cannot be accomplished with recordkeeping and reporting. First, they ensure real time post-trade transparency so that all market participants can see where listed derivatives trade. Second, they promote pre-trade transparency for transactions other than those eligible for appropriate block trading exceptions. This would lower bid-ask spreads and ensure better pricing for derivatives users and their customers. Third, they lower risk by legally matching or affirming trades. Fourth, they have self-regulatory functions to police for fraud, manipulation and other abuses in the marketplace.

The Senate Banking Committee bill has a robust transparent trading requirement that would apply to all standardized derivatives that are clearable and listed. This is an essential component of reform. While the House bill includes a similar trading requirement, it may exempt many transactions when they are between a dealer and an end-user, such as insurance companies, finance companies or potentially even hedge funds. Reform should bring all standardized transactions into transparent trading.

Centralized Clearing

To further lower risk in the over-the-counter derivatives marketplace, all standardized derivatives should be cleared through central clearinghouses. I understand from your public letters that this is also something you support. Clearinghouses act as middlemen between two parties to a transaction and guarantee the obligations of both parties. When transactions aren't cleared, they stay on the books of the derivatives dealers for many years. This enables dealers to become dangerously interconnected with each of their counterparties, as we saw with AIG. Clearinghouses move the risk off of the books of the dealers and into robustly regulated central counterparties.

Some derivatives are highly tailored to meet the particular needs of particular hedgers, and those contracts should not be subject to a clearing requirement. We should, however, ensure through dealer regulation that capital requirements account for the additional risk posed by customized bilateral derivatives transactions. Authority to set capital requirements, though, is not sufficient. We also must ensure that regulators can set margin requirements on bilateral trades as appropriate. The House and Senate Banking Committee bills accomplish these goals.

It is essential that we move as many over-the-counter derivatives transactions into central clearing as possible. We should not enact broad exemptions for particular transactions based on which party stands on one side of the trade. It is important to note that while American taxpayers were not required to cover market exposures on any cleared futures transactions, they had to bail out AIG and others in part to cover uncleared derivatives contracts. Thus, the more transactions that are cleared, the better protected the American public is.

To ensure fairness and competition, OTC derivatives clearinghouses should have open access and be required to take on trades from any regulated exchange or swap execution facility. Clearinghouses should not be allowed to discriminate between or amongst the trades coming from one trading venue or another. Some of the existing clearinghouses have expressed reservations about provisions included in the House and Senate Banking Committee bills that would establish such open access. But dropping this provision would only lessen competition and allow OTC derivatives clearinghouses to establish barriers to entry.

To ensure that clearinghouses are not governed by parties that might have a conflict of interest or financial stake in particular transactions, market regulators should have authority to write rules to protect against such conflicts. Lastly, clearinghouses should have open membership that is transparent, objective and nondiscriminatory.

The Senate Banking Committee legislation has a strong clearing requirement for standardized contracts and limits exemptions to only those that market regulators approve. The House bill also has a strong clearing requirement, but it may leave out a large portion of the market comprised by transactions between derivatives dealers and their customers. While a transaction between two Wall Street banks, for example, would be subject to a clearing requirement, a transaction between a bank and one of its customers might not be covered. At a minimum, we should ensure that every transaction between Wall Street banks and their financial customers, such as hedge funds, insurance companies or leasing companies, be subject to a clearing requirement.

Closing

In 2008, the financial system failed, and the financial regulatory system failed. The results have been calamitous. While the stock market has rebounded and many Wall Street banks have paid back some of their TARP money, the American public is still largely unprotected from the risks associated with the over-the-counter derivatives marketplace. Financial reform will be incomplete if it does not bring robust, comprehensive regulation to this market.

Thank you, and I'd be happy to take your questions.